

## Message Text

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DEPARTMENT PASS TREASURY AND FRB

E.O. 11652: N/A

TAGS: EFIN, UK

SUBJECT: INTERNATIONAL BANK LENDING IN 1975; U.K. VIEWS

REF: STATE 22709; STATE 27493

SUMMARY: U.K. CLEARING BANKS ARE RUNNING SCARED, BUT WITH NO SENSE OF IMPENDING CRISIS. THEY ARE INCREASINGLY ANALYZING RISK, CONSOLIDATING, SHIFTING FROM INTERBANK TO COMMERCIAL LENDING TRANSACTIONS. DISTINCTION MADE BETWEEN GUIDELINES IN STERLING AND EUROCURRENCY LENDING. VOLUME OF EACH EXPECTED TO GROW, WITH TREND TOWARDS WIDER SPREADS, SHORTER MATURITIES, MORE COMMERCIALLY LINKED TRANSACTIONS TO CONTINUE. ADEQUACY OF BANK CAPITAL NOT AN IMMEDIATE PROBLEM. MANY FACTORS, INCLUDING OUTLOOK FOR COMMODITY PRICES, LEVEL OF EXTERNAL DEBT AND RESERVES, IMPORTANT IN SETTING COUNTRY EXPOSURE LIMITS; THEY ARE NOT INFLEXIBLE. SUPPORT FROM OPEC, INDUSTRIALIZED COUNTRIES, LIMITED OFFICIAL USE

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IMF/OECD COULD RESULT IN INCREASED LENDING TO COUNTRIES IN

DIFFICULTY IF BANKS CAN BE SURE IT OFFERS A FIRM GUARANTEE THAT LOANS WILL BE REPAYED; OTHERWISE NOT. FEARS EXPRESSED OF DOMINO EFFECT SHOULD SIZABLE OR MAJOR PRIVATE OR GOVERNMENTAL BORROWER DEFAULT. NEED CITED FOR CLEAR LENDER OF LAST RESORT FACILITIES AND QUICK GOVERNMENT SUPPORT ACTION WHEN SUCH DIFFICULTIES ARISE. END SUMMARY.

1. A. FINANCIAL ATTACHE MADE APPROACH TO BANK OF ENGLAND AND FIVE OFFICERS IN TWO OF LARGEST U.K. CLEARING BANKS. STRUCTURE OF THIS MESSAGE IS GEARED TO QUESTIONS IN WASHINGTON REFTEL 22709. ALMOST ALL OF POINTS RAISED IN REFTEL WERE TOUCHED ON DURING LENGTHY DISCUSSIONS. BANK VIEWS WERE GIVEN IN CONFIDENCE. QUANTITATIVE ASSESSMENT LIKELY VOLUME 1975 INTERNATIONAL LENDING VAGUE; WITH SHARPER VIEWS ON IMPACT OF VARIOUS FACTORS IN DECISION MAKING; BANK OF ENGLAND IN GENERAL CONSIDERED CONSTRAINTS ON MANY SMALLER INTERNATIONAL BANKS MIGHT NOT APPLY TO CLEARING BANKS BECAUSE THEY ARE LARGE, WELL KNOWN, INTERNATIONALLY RESPECTED INSTITUTIONS THAT THE BANK OF ENGLAND AND GOVERNMENT WILL SUPPORT. CLEARING BANKS WILL CONTINUE TO COMPETE INTERNATIONALLY, GETTING A FAIR SHARE OF GOOD QUALITY BUSINESS ALTHOUGH WITH LITTLE STERLING LENDING NOT ASSOCIATED WITH U.K. EXPORTS BECAUSE OF BALANCE OF PAYMENTS CONSTRAINTS.

B. CLEARING BANKS ECHOED THIS, ONE SAYING INTERBANK LENDING (I.E., PROFESSIONAL DEALING) WOULD CONTINUE TO BE CUT BACK AS A PERCENTAGE OF OPERATIONS; COMMERCIAL LENDING WOULD INCREASE; THIS BANK'S OVERALL PROJECTED GROWTH OF INTERNATIONAL LENDING IN ALL CURRENCIES IN 1975 IS IN RANGE OF 40 PERCENT, DESPITE STRONG MEASURES OF CONSOLIDATION. THERE WOULD BE INCREASED UTILIZATION OF COUNTRY LIMITS: PERHAPS SOME INCREASE IN STERLING LENDING TO U.S. COMPANIES IN THE U.K.; INTERNATIONAL LENDING BEING GENERALLY CONFINED TO WORLD'S THOUSAND LARGEST COMPANIES. RISK/REWARD FACTORS WILL BE VIEWED MORE CRITICALLY.

C. OTHER CLEARER WOULD NOT ATTEMPT GIVE QUANTITATIVE ESTIMATE, SAW GOOD GROWTH IN LENDING VOLUME IN EURO-CURRENCIES; NOT MUCH IN STERLING; FAIRLY SIZABLE INCREASE LIMITED OFFICIAL USE

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IN LENDING DOMESTIC CURRENCIES IN COUNTRIES WHERE IT HAS LOCAL DEPOSIT BASE, AS U.S. AND NIGERIA. POOR WORLD ECONOMIC OUTLOOK, WORLDWIDE PROBLEMS ASSOCIATED WITH INCREASED OIL PRICE AND POLITICAL INSTABILITY HAVE SHIFTED SCENE FROM BORROWERS TO A LENDERS MARKET. BANKS NOW HAVE THE INITIATIVE. LENDING PURPOSES HAVE CHANGED (I.E., SHIFT AWAY FROM INTERBANK, PROFESSIONAL DEALING). IN COMMERCIAL LENDING, BANKS LOOK MORE CLOSELY FOR A CLEAR SOURCE OF

PAYMENT, THEY ARE SEEKING A REDUCTION IN MATURITIES AND INCREASED SPREADS (1-1/2 TO 1-3/4 DESIRED ABOVE SIX MONTHS AS THE IDEAL, BUT NOT ALWAYS OBTAINABLE, AND MATURITIES NOT IN EXCESS OF FIVE YEARS) WITH A CLEAR UNDERLYING TRADE FACTOR IN THE TRANSACTION. BANKS ARE FED UP WITH COMPETITION AT ANY PRICE AND ARE WORRIED ABOUT THE DOMINO EFFECT, FRIGHTENED ABOUT WHAT WOULD HAVE HAPPENED TO INTERNATIONAL

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MARKETS IF BANK OF ENGLAND HAD NOT STOOD BEHIND BURMAH. PRESUMABLY THERE ARE MORE SUCH CASES TO COME IN INTERNATIONAL LENDING. LENDING IN DOLLARS TO BANKS WITHOUT A DOLLAR BASE WILL BE VIEWED MORE CRITICALLY.

2. A. PRINCIPAL UNCERTAINTIES DIVIDED AMONG LENDING IN STERLING AND DOLLARS. BANK OF ENGLAND FOREIGN EXCHANGE CONTROL REGULATIONS, GUIDELINES ON BANKS' FOREIGN EXCHANGE OPERATIONS (LONDON A-58, JANUARY 20, 1975) AND QUALITATIVE

GUIDANCE ON STERLING LENDING FAVORING PRODUCTIVE, COMMERCIAL, EXPORT ACTIVITIES OVER FINANCIAL AND PERSONAL LENDING ARE WELL KNOWN AND LIKELY TO CONTINUE. ASSUMING U.K. REMAINS IN EC, EXCHANGE CONTROLS EXPECTED TO BE PROGRESSIVELY RELAXED TOWARDS THAT AREA BY 1980. THERE ARE NO QUALITATIVE BANK OF ENGLAND CONTROLS OR GUIDELINES OVER LENDING OF ENTREPOT EUROCURRENCY DEPOSITS TO FOREIGN TAKERS. BANK OF ENGLAND EXPECTS MOST U.K. FINANCIAL INSTITUTIONS IN DOMESTIC OPERATIONS TO HAVE ONE POUND EQUITY

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FOR EACH TEN POUND DEPOSIT, WITH ASSET SIDE OF BALANCE SHEET SHOWING RATIO OF ABOUT 3.3 IN QUICK ASSETS TO 7.7 IN LONGER TERM LOANS AND ADVANCES. THESE RULE OF THUMB RATIOS CONSIDERED FAR LESS A PROBLEM AND ARE MORE FLEXIBLE AND VAGUE FOR CLEARERS, WHICH REPORTEDLY MAINTAIN CAPITAL TO DEPOSIT RATIO ON DOMESTIC OPERATIONS IN RANGE OF ONE TO 13 TO 16 (I.E., 6 TO 8 PERCENT) AND ONE TO 20 (I.E., FIVE PERCENT) IN INTERNATIONAL OPERATIONS. BANK OF ENGLAND IS CURRENTLY REVIEWING ADEQUACY OF CAPITAL RATIOS, CONSIDERS MAIN POINT IS FOR BANKS TO BE ABLE TO COVER BAD DEBTS. LEVEL OF NECESSARY CAPITAL TO SOME EXTENT DEPENDS ON QUALITY OF ASSETS. ALL AGREED CAPITAL RATIOS WOULD BE UNDER PRESSURE, KEY QUESTION WAS POSITION TO TAKE AS A RESULT.

B. MATURITY DIFFERENTIAL, CONCENTRATION OF DEPOSITS WAS IDENTIFIED AS OBVIOUS AREA OF CONCERN. SHIFTING YIELD STRUCTURE COULD RESULT IN CHANGES IN STRUCTURE OF DEPOSITS LESS INTERBANK DEALING WILL SHIFT BALANCE SHEET STRUCTURE OF ASSETS IN FAVOR OF LONGER TERM COMMERCIAL LENDING AT SAME TIME BANKS ARE TRYING TO REDUCE MATURITIES IN NEW COMMERCIAL LENDING. THERE WILL BE FEWER SYNDICATED LOANS; FEWER DEALINGS WITH CONSOFTIA BANKS; MULTISTRUCTURE DEPOSIT BASIS AMONG BANKS WILL CONTINUE; THERE IS NO REASON LARGER MORE SOLID BANKS SHOULD PAY AS MUCH FOR FUNDS AS SMALLER ONES; OPEC DEPOSITS HAVE NOT PROVED UNSTABLE, ALTHOUGH THERE ARE SIGNS OF REDUCED INFLOWS IN STERLING. TO EXTENT POSSIBLE, BANKS WILL TRY TO MAINTAIN BALANCED BOOK, BUT KNOW IT IS NOT TOTALLY POSSIBLE, ESPECIALLY GIVEN HEAVY PRESSURE TO TAKE IN SHORT-TERM OPEC FUNDS AND LEND THEM ONWARDS.

C. GOVERNMENT AND COUNTRY RISK EVALUATION IS SHOWING INCREASED CAUTION. THERE ARE REAL FEARS ON BOTH REPAYMENT AND SERVICE, BUT THE GENERAL OUTLOOK IS MORE CONFIDENT THAN IT WAS SIX MONTHS AGO. THERE CERTAINLY WILL BE MORE SPECIFIC AD HOC DIFFICULTIES; CONTINUED CONFIDENCE IN THE SYSTEM WILL DEPEND ON HOW CENTRAL AUTHORITIES DEAL WITH THEM. SMALLER EUROPEAN COUNTRIES AND ITALY ARE BEING

WELL MONITORED. CLEARERS EXPECTED NON-U.K. BANKS ARE  
KEEPING CLOSE WATCH ON THE U.K. SITUATION. NOT MUCH SCOPE  
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SEEN FOR LENDING TO LDCS, EXCEPT ON TRADE RELATED, SHORT-TERM BASIS; ONE CLEARER THOUGHT SOME LDCS WOULD HAVE TROUBLE ROLLING OVER OUTSTANDING LOANS.

D. LOOKING AHEAD, ONE CLEARER EXPECTED ITS INTER-NATIONAL LENDING WOULD BE CONSTRAINED BY HEAVY FUTURE BORROWING DEMANDS ASSOCIATED WITH FINANCING NORTH SEA OIL DEVELOPMENT. THIS BANK SAW NORTH SEA LENDING MORE THAN OFFSETTING ANY FALL OFF IN LENDING ELSEWHERE, FORESAW ALL CLEARING BANKS MAKING HEAVY COMMITMENTS IN 1975 AND 1976, WITH ACTUAL DRAW DOWNS IN 1976 AND 1977; OTHER CLEARER ECHOED THIS GENERAL SITUATION, BUT SAID IT WOULD NOT LEND ANYTHING FOR NORTH SEA DEVELOPMENT UNTIL U.K. GOVERNMENT CLARIFIES CURRENT UNCERTAINTIES, INCLUDING LEVEL OF RETURN ON INVESTMENT AND PROFITS.

3. A. CONSIDERABLE THOUGHT IS BEING GIVEN TO MEANS OF INCREASING BANK CAPITAL; BANK OF ENGLAND IS NOT PREPARED TO SEE A CLEARING BANK TAKEN OVER AND CONTROLLED BY FOREIGN CAPITAL. HOWEVER, THIS DOES NOT MEAN FOREIGN CAPITAL COULD NOT BE INJECTED IN SOME FORM. WITH REVIVAL OF U.K. STOCK MARKET, BANK OF ENGLAND WOULD CERTAINLY SUPPORT PROPOSITION THAT CLEARING BANKS COULD BE AMONG FIRST TO COME TO MARKET FOR CAPITAL. FOREIGN FUNDS MIGHT BE

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ACCOMMODATED THROUGH SUBORDINATED DEBT ISSUES WITH NO VOTING RIGHTS. ONE CLEARER SAW NEED TO RETAIN AND BUILD BALANCE SHEET CAPITAL TO BALANCE INFLATIONARY DEPOSITS, SAID IT WAS EXPLORING POSSIBILITY OF RAISING CAPITAL FROM NON-STOCK MARKET SOURCES, POSSIBLY PRIVATE PLACEMENTS, DEBT ISSUES, OR CAPITAL IN FOREIGN CURRENCIES THAT COULD BE LINKED TO ITS FOREIGN OPERATIONS. THE OTHER CLEARER CONSIDERED THAT GIVEN HUGE SIZE OF ITS DEPOSITS AND ASSETS, A MASSIVE EQUITY FLOTATION WOULD BE NECESSARY TO MAKE A NOTICEABLE INCREASE, AND WAS NOT SURE THIS IS OR SHOULD BE NECESSARY. THE MAIN POINT IS TO HAVE SUFFICIENT CASH FLOW AND PROFITABILITY TO MEET BAD DEBTS.

B. BOTH CLEARERS IDENTIFIED NEED OF LENDER OF LAST RESORT UNDERTAKINGS. RECENT PRONOUNCEMENTS FROM BASLE HAVE HELPED' BUT NOT TOTALLY CLARIFIED SITUATION. IN U.K. THERE IS WIDELY HELD VIEW THAT BANK OF ENGLAND WILL ALWAYS STAND BEHIND CLEARING BANKS. ONE CLEARER SAID THERE HAS

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BEEN RECENT BAD PUBLICITY IN U.S. (A RECENT BARRON'S ARTICLE CITED IN PASSING) ABOUT POSITION OF CLEARING BANKS AFTER THEIR SUPPORT OF SECONDARY BANKS WHICH HAD BECOME ILLIQUID. VERY SENIOR OFFICIAL OF THIS BANK WAS ADAMANT THAT THE SUPPORT OPERATION HAS NOT AND WILL NOT AFFECT STABILITY OF CLEARING BANKS, ASKED THAT THIS POINT BE MADE TO WASHINGTON. HE SAID BALANCE SHEETS OF CLEARING BANKS WILL SHOW PROVISION FOR LOSSES GREATER THAN IN 1974, BUT ACTUAL LOSSES WILL BE MINIMAL, WITH MOST OF THE SUPPORT LENDING SECURED. HE CONSIDERED THIS INVOLVEMENT SMALL PRICE TO PAY FOR MAINTAINING STABILITY AND REPUTATION OF THE STERLING FINANCIAL MARKET AND U.K. BANKING SYSTEM.

4. A. ONE CLEARING BANK ASSESSED COUNTRY AND GOVERNMENT

RISKS ON THE BASIS OF A WEIGHTED INDEX, WITH EXTERNAL DEBT, RESERVES, AND COMMODITY INCOME RELIANCE GIVEN QUITE HIGH WEIGHT, AND POLITICAL RISK AND FINANCIAL SOPHISTICATION (THE NUMBER OF BANK CREDIT LINES, ABILITY TO HANDLE FINANCIAL MARKET TRANSACTIONS, ETC.) LOWER WEIGHT. THE OTHER CLEARER USED THESE FACTORS ON A MORE SUBJECTIVE BASIS, ADDING IN IMPRESSIONS FROM REGULAR VISITS, AND VIEWS OF EMBASSIES AND DOMESTIC COMMERCIAL BANKS IN FOREIGN COUNTRIES. IT ADDED THAT BASED ON ITS ASSESSMENT, IT HAD CUT BACK SHARPLY BUT NOT INDISCRIMINATELY ON ITS

LIMITS OVER THE PAST TWELVE MONTHS, INCLUDING SMALLER BANKS IN THE U.S.

B. DISCUSSION OF COUNTRY EXPOSURE LIMITS BROUGHT FORTH SIMILAR, BUT NOT IDENTICAL VIEWS. BANK OF ENGLAND CONSIDERED IF THEY ARE USED, THEY ARE NOT PARTICULARLY FLEXIBLE. THEY ARE IMPOSED TO DEAL WITH A RISK; UNLESS THE RISK IS REMOVED, WILLINGNESS TO PAY ABOVE MARKET RATES MAY NOT BE SIGNIFICANT FACTOR IN GETTING MORE FUNDS. RISKS WILL NOT BE TAKEN IF PROTECTION OF DEPOSITORS FUNDS HAS BECOME A MAJOR CONSIDERATION. THIS MUCH SAID, THERE WOULD BE MORE WILLINGNESS TO LEND SHORT-TERM (AT HIGH RATES) SINCE IMMEDIATE RISK IN THESE SITUATIONS CAN BE BETTER ASSESSED.

C. ONE CLEARER THOUGHT COUNTRY EXPOSURE LIMITS LIMITED OFFICIAL USE

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COULD BE INCREASED ON PROJECTS WITH GOOD CHANCE OF REPAYMENT; THEY CAN BE FLEXIBLE, BUT ARE SET BY SENIOR MANAGEMENT AND ARE NOT EASILY CHANGED. THERE ARE VARIOUS FORMS OF EXPOSURE RISK LIMITS, BY COUNTRY, CURRENCY, CLIENT, INDUSTRY, AND MATURITY. IT IS A MATTER OF JUDGMENT, TEMPERED BY CHANGING CONDITIONS. LAST YEAR, MANY BANKS UNDERESTIMATED THE RISKS. AT THE MOMENT, THIS BANK WILL NOT LEND TO SHIP OWNERS, REGARDLESS WHERE. THE OTHER CLEARER ALSO CITED THE DIFFICULTY OF ASSESSING RAPID CHANGE, SAID TRENDS IN COMMODITY PRICES COUNT A GREAT DEAL. ITS OWN LIMITS ARE NOT INFLEXIBLE, WOULD VERY LIKELY BE INCREASED TO SUPPORT U.K. EXPORTS.

D. BANK OF ENGLAND CONSIDERED INCREASED INDUSTRIAL OR OPEC GOVERNMENT AND IMF/OECD ARRANGEMENTS WOULD OBVIOUSLY BE HELPFUL IN INCREASING BANK LENDING IF WATERTIGHT, WITH CONCRETE, PRECISE, TAKE OUT PROVISIONS FOR THE BANK LENDER. OTHERWISE OF LIMITED OR LITTLE EFFECT. THIS GENERALLY ECHOED BY CLEARERS. ONE SAID A DEGREE OF INTERNATIONAL SUPPORT WOULD INFLUENCE ATTITUDES AND POLICIES PROVIDED IT WOULD HELP REPAYMENT; LENDING TO EGYPT AND

SUDAN HAS BENEFITED BECAUSE OF SAUDI SUPPORT OR GUARANTEES  
OTHER CLEAKER WAS MORE QUALIFIED IN RESPONSE; WHAT AIDS  
GENERAL STABILITY WILL AID MARKET STABILITY, BUT OECD OR  
IMF FUNDS FOR ITALIAN GOVERNMENT DOESN'T MEAN COMMERCIAL  
BANKS WILL VIEW LENDING ANY DIFFERENTLY. THERE MIGHT BE

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SOME LIMITED IMPACT ON EXPOSURE LIMITS BUT BASICALLY A  
PROJECT IS COMMERCIALLY VIABLE OR IT IS NOT. A GOOD COM-  
PANY IN A HIGH RISK COUNTRY AS ITALY CAN RAISE FUNDS FROM  
BANKS MORE EASILY THAN THE ITALIAN GOVERNMENT; NEED FOR  
BILATERAL SUPPORT BETWEEN GOVERNMENTS MAY SIMPLY RECONFIRM  
THIS VIEW.

E. AS ALREADY NOTED, 1975 WILL SEE ATTEMPTS TO SHOR-  
TEN MATURITIES, NOT NECESSARILY WIDEN SPREADS, BUT CER-  
TAINLY ATTEMPT TO MAINTAIN THEM AT EXISTING LEVELS; MORE  
EFFORT WILL BE MADE TO MATCH THE BOOK; THERE WILL BE MORE

ATTENTION TO RISKS AS THE BANKS RUN SCARED, CONTINUE DEFENSIVE POSTURE IN LENDING; HARD GUARANTEES WILL BE SOUGHT FROM PARENTS RATHER THAN COMFORT LETTERS; REQUIREMENTS OF REPAYMENT AGAINST BORROWERS' EARNINGS WILL BE TIGHTENED; FORWARD MARKET OPERATIONS WILL CONTINUE TO BE CIRCUMSCRIBED; AS WILL INTERBANK OPERATIONS IN CURRENCIES IN WHICH THE BANKS DO NOT HAVE A DEPOSIT BASE. ALL THIS

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SAID, THERE IS A FEELING THAT THE SYSTEM IS SOUNDER THAN IT WAS SIX MONTHS AGO WITH NO IMMEDIATE SENSE OF IMPENDING CRISIS.

5. INDIVIDUAL CLEARING BANK ANNUAL REPORTS FOR 1974 NOT YET AVAILABLE, WILL BE FORWARDED TO WIDMAN, TREASURY, LATER THIS MONTH. ALL SOURCES CITED QUARTERLY BANK OF ENGLAND BULLETINS AS BEST OVERALL SOURCE OF QUANTITATIVE DATA REQUESTED, ALTHOUGH ENTIRE YEAR 1974 DATA WILL NOT BE AVAILABLE UNTIL MARCH 1975 ISSUE PUBLISHED.

6. EMBASSY GRATEFUL FOR ADDITIONAL GUIDANCE IN STATE 27493. A SUPPLEMENTARY REPORT WILL BE SENT AFTER AN APPOINTMENT THIS WEEK WITH A MAJOR U.S. BANK. BANK OF ENGLAND EXPRESSED APPRECIATION FOR BEING INFORMED AND INVOLVED' VOLUNTEERING THAT INITIAL APPROACH TO BOE WAS VERY MUCH IN ORDER.

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## Message Attributes

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**Current Classification:** UNCLASSIFIED  
**Concepts:** POLICIES, BANKS, CAPITAL FLOWS  
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**Draft Date:** 10 FEB 1975  
**Decaption Date:** 01 JAN 1960  
**Decaption Note:**  
**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
**Disposition Authority:** GolinoFR  
**Disposition Case Number:** n/a  
**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 28 MAY 2004  
**Disposition Event:**  
**Disposition History:** n/a  
**Disposition Reason:**  
**Disposition Remarks:**  
**Document Number:** 1975LONDON02063  
**Document Source:** CORE  
**Document Unique ID:** 00  
**Drafter:** n/a  
**Enclosure:** n/a  
**Executive Order:** N/A  
**Errors:** N/A  
**Film Number:** D750048-0256  
**From:** LONDON  
**Handling Restrictions:** n/a  
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**Legacy Key:** link1975/newtext/t19750257/aaaabznr.tel  
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**Office:** ACTION TRSE  
**Original Classification:** LIMITED OFFICIAL USE  
**Original Handling Restrictions:** n/a  
**Original Previous Classification:** n/a  
**Original Previous Handling Restrictions:** n/a  
**Page Count:** 9  
**Previous Channel Indicators:** n/a  
**Previous Classification:** LIMITED OFFICIAL USE  
**Previous Handling Restrictions:** n/a  
**Reference:** 75 STATE 22709, 75 STATE 27493  
**Review Action:** RELEASED, APPROVED  
**Review Authority:** GolinoFR  
**Review Comment:** n/a  
**Review Content Flags:**  
**Review Date:** 15 MAY 2003  
**Review Event:**  
**Review Exemptions:** n/a  
**Review History:** RELEASED <15 MAY 2003 by ifshinsr>; APPROVED <19 MAY 2003 by GolinoFR>  
**Review Markings:**

Margaret P. Grafeld  
Declassified/Released  
US Department of State  
EO Systematic Review  
05 JUL 2006

**Review Media Identifier:**  
**Review Referrals:** n/a  
**Review Release Date:** n/a  
**Review Release Event:** n/a  
**Review Transfer Date:**  
**Review Withdrawn Fields:** n/a  
**Secure:** OPEN  
**Status:** NATIVE  
**Subject:** INTERNATIONAL BANK LENDING IN 1975; U.K. VIEWS  
**TAGS:** EFIN, UK  
**To:** STATE  
**Type:** TE  
**Markings:** Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 05 JUL 2006